

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

October 5, 2006

The Honorable TED STEVENS

President Pro Tempore of the U.S. Senate, Washington, D.C. 20510

The Honorable J. DENNIS HASTERT

Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR STEVENS AND SPEAKER HASTERT:

We are pleased to transmit the record of our June 7-8, 2006 public hearing on “*Intellectual Property Rights Issues and Imported Counterfeit Goods.*” The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, sect. 635(a)) provides the basis for this hearing, as it requires the Commission to report on “the degree of non-compliance by the People’s Republic of China with agreements between the United States and the People’s Republic of China on . . . intellectual property rights, and United States enforcement policies with respect to such agreements” and “the compliance of the People’s Republic of China with its accession agreement to the World Trade Organization (WTO).” An electronic copy of the full hearing record is posted to the Commission’s Web site at www.uscc.gov.

The testimony offered at the hearing clearly showed that China fails to enforce intellectual property rights (IPR). The requirement to enforce such international rules of commerce is a fundamental obligation of membership in the World Trade Organization (WTO), and for good reason: advanced economies especially depend on the innovation of inventors and visionaries. American IP industries, for example, contribute to more than half of all U.S. exports and represent 40 percent of U.S. economic growth, according to the Department of Commerce. Fifty-five percent of U.S. companies operating in China were hurt by intellectual property rights violations, according to a survey of U.S.-based businesses operating in Beijing. Even the Chinese authorities estimate that counterfeit and pirated products in China amount to between \$19 billion and \$24 billion per year, 8 percent of China’s GDP.

Despite repeated promises to do so, China has not significantly reduced its high copyright infringement rates. According to the U.S. recording industry, 85 percent of sound recordings sold in China were pirated in 2004, or 17 of every 20 sold there. For motion picture recordings, the piracy rate is almost 100 percent. Across all copyright industries, piracy rates in 2005 remained between 85 and 93 percent, according to the office of the U.S. Trade Representative (USTR).

Chinese Government's Lack of Will

Entire local economies in China may rely on the profits derived from the sale of counterfeit goods. In some cases, administrative and law enforcement officials at the local level are directly or indirectly involved in counterfeit goods production and distribution. When the violator is a major employer or taxpayer, local officials find it doubly hard to kill the golden goose. According to Daniel C.K. Chow of Ohio State University, the town or city may depend almost entirely on the illegal enterprise to generate funds for education or health care. At the same time, organized crime, particularly in southern China, is involved in the manufacture and distribution of pirated goods. Both Professor Chow and Neil Livingstone of Global options Inc. testified that criminals help extend local counterfeit markets to the international level using direct exports or through connections to organized crime networks in Hong Kong and Taiwan.

Consumers are freely able to purchase pirated goods through wholesale and retail markets in China and need not use any underground economy or black market. For example, Professor Chow stated, in Yiwu, the wholesale market thrives on counterfeit goods. It was established with government investment and is now the largest taxpayer in Yiwu. Since the same local government that established the market is also responsible for enforcing laws and regulations against counterfeiting, it is no wonder that local enforcement is nil.

While most Chinese local governments do not appear to have the will to enforce IPR, the central government's resolve to address the issue is not much stronger. Though there is no coordinated national plan to encourage IP theft, such violations often are tolerated. While some in the central government take intellectual property rights seriously, others see piracy as a typical path for developing nations attempting to foster economic development. For example, if members of the central government strive to develop a globally competitive company in China and believe foreign technology might facilitate that goal, the government may allow the company to obtain the technology illegally. Various economic justifications are advanced to explain the lack of enforcement. Should the central government initiate a national crackdown on IP infringement, cities like Yiwu would be devastated, with tens of millions unemployed, say advocates of non-enforcement. Either the central government would have to tackle and ameliorate severe economic and social consequences, or it would have to face the impacts of those severe consequences.

In theory, a developing nation might improve IPR protection within its borders to attract foreign direct investment (FDI), particularly to attract high-value-added industries. But in China's case, the level of FDI remains high despite the lack of improvement in IPR protection. However, the level of foreign investment in basic research projects remains low, as foreign companies protect their key IP from exposure to China's pirates. The "innovation society" China is promoting during implementation of its 11th Five Year Plan could lead to increased levels of higher-end technological IP and thus require an increase in patent protection. But while the central government has some incentive to improve patent protection in order to protect future Chinese innovations, there is no such incentive with respect to already- copyrighted material.

Legislation and Enforcement

China does not currently make use of effective measures for enforcing its IPR laws and regulations. Without the vigorous use of effective enforcement tools, any efforts to crack down on IPR infringement are doomed. According to the USTR, “China’s own 2004 data showed that it channeled more than 99 percent of copyright and trademark cases into its administrative systems and turned less than one percent of cases over to the police. The trademark and copyright industries continue to point out that administrative fines are too low to provide a deterrent, and as a result, pirates consider administrative seizures and fines to be merely a cost of doing business.”

China already has incorporated in its IPR law Articles 9-14 of the WTO’s Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement. However, the legislation it uses to fulfill its obligations is often inadequate. For example, during the 2005 meeting in Washington of the U.S.-China Joint Commission on Commerce and Trade, (JCCT), China agreed to enact legislation fulfilling World Intellectual Property Organization (WIPO) internet treaty obligations. But when the USTR examined the implementing legislation, it found the purported legal protections were ruined by loopholes.

Currently, there are three types of IPR enforcement mechanisms in China, all with their own deficiencies:

- *Administrative Enforcement*, which occurs at the local level, is riddled with local foot-dragging and token penalties. In 2004, there were 51,851 administrative cases of trademark infringement and counterfeiting, only 5,494 of which involved foreign rights holders. The average fine was \$620 per case and only 96 cases were referred for criminal prosecution. That same year there were 9,691 copyright infringement cases, 158 involving a foreign rights holder, of which only 102 cases were referred for criminal prosecution.
- *Civil Enforcement* does provide a specialized, IPR-trained judiciary and nationwide jurisdiction. However, China’s judiciary is not independent. Further, damages awarded by Chinese courts are difficult to collect. From January to November 2005, there were 11,468 IP-related civil cases (5,240 copyright, 2,491 patent, and 1,482 trademark cases), about 5 percent of which involved foreign rights holders.
- *Criminal Enforcement* does provide some means of deterring piracy, such as the ability to imprison offenders. A 2004 judicial interpretation lowered the thresholds for criminal cases and included new provisions addressing online copyright piracy, accomplice liability, and the import and export of infringing goods. However, questions remain unanswered about how to assign value to seized goods. Additionally, prosecutors must prove the piracy activity generated a profit and the merchant knew the goods were counterfeit. Judicial interpretation eliminated a “three strikes” rule that required criminal prosecution for third-time repeat offenders. The pace of prosecution is glacial: China’s Public Security Bureau (PSB) initiated 2,991 IP criminal cases *in 2005*, with 261 cases concluded and 2,661 still moving through the system.

Export of Counterfeits

China's customs enforcement personnel seize only a limited amount of counterfeit goods, but what they do catch shows that the vast majority of goods are meant for foreign distribution. Of 1,052 seizures in 2004, 98 percent were destined for export.

In 2005, products of Chinese origin accounted for 69 percent of total product seizures at the U.S. border or more than ten times the product seizures of imports from any other trading partner. Still, such seizures at U.S. ports are only a fraction of the actual imports of counterfeit goods; this is not surprising since the Department of Homeland Security (DHS) has not placed the seizure of counterfeit goods among its top enforcement priorities. Even so, the value of goods seized by DHS's Immigration and Customs Enforcement (ICE) unit thus far in FY2006 already has surpassed the total value seized in FY2005. The great majority of those items seized were exported by China.

Exports of bogus products from China likely will continue to increase. China previously granted export and import rights only to state-owned trading companies. However, due to its WTO obligations, in July 2004, China amended the law so that any business operator could register to export; this eliminated the extra step – of using a state-owned company as a middle man – that both legitimate exporters and counterfeiters had to take in order to distribute internationally. The result is a reduction in government control that makes it easier for counterfeiters to export their products.

U.S. Industry

Chinese access to the technologies of U.S. patent holders often is acquired when U.S. companies invest in China. Sometimes technology acquired in this way is diverted to China's illegitimate economy. However, FDI or any other U.S. industry presence is not required for Chinese IP infringement. The U.S. Patent and Trademark Office (USPTO) advises that all U.S. businesses that plan to have an internet presence, international trade show, or other similar exposure, regardless of whether they plan to manufacture, market, or engage a Chinese entity, should plan carefully to protect their IP.

Multinational corporations (MNC) tolerate a certain level of IP infringement to operate in China, often without publicly complaining for fear of being shut out of the China market. For example, Microsoft Chairman Bill Gates has thanked the Chinese government for its improvements in IP protection, while at the same time the company's managers in China are grappling with a \$10 billion-a-year loss due to Chinese infringement. Nevertheless, Microsoft has invested in research and development facilities located in China. This type of corporate double-speak allows the Chinese government to hide behind cosmetic changes to its IPR protection laws and enforcement procedures while undertaking no significant changes.

For small and medium sized enterprises (SMEs), IP infringement can be devastating. This sector is critical to America's IP-rich economy. Pat Choate of the Manufacturing Policy Project recounted to the Commission his estimate that 45 percent of all U.S. inventions are the products of SMEs, individual inventors, universities, or research institutions. "Increasingly, counterfeiters are targeting American small and medium-

sized enterprises and thereby seriously undermining their ability to compete in global markets.”

Market access barriers prevent U.S. companies from entering and serving the Chinese market efficiently. This provides an opportunity for pirates to operate in the market before or in place of U.S. companies. Market access restrictions, such as delays in regulatory approval and restrictions on distribution rights, “artificially limit the availability of foreign content and thus lead consumers to the black market.” U.S. movie makers, whose showings are limited to a handful of films allowed into Chinese theaters, are a frequent target of counterfeiters since consumers can’t see the movies on the big screen. Furthermore, industries not permitted to operate independently in China face additional vulnerabilities. For example, foreign publishers are not permitted to operate in China and each must partner with a local publisher, some of whom are not interested in protecting foreign copyrights and may, in fact, steal the foreign publisher’s IP.

At present, there are no established means whereby U.S. importers can be confident that they are not importing counterfeit goods from China and therefore may be incurring liability. In his testimony to the Commission, Pat Choate suggested that the United States should require each country placed on the USTR’s “Priority Watch” list – an annual report to Congress on IPR transgressors that prominently includes China– to provide a certificate of authenticity from the manufacturer of every item imported from that country, verifying that the item is not a counterfeit. By making it far less likely that counterfeit goods can enter and be sold in the United States, such a measure would serve three important purposes: it would combat piracy by reducing its profitability; it would significantly increase protection for Americans from the sometimes catastrophic failures of sensitive counterfeit goods such as auto and aircraft parts and pharmaceutical products, and from the economic costs of other counterfeit failures; and it would substantially reduce the problem of liability claims, and the costs of defending against those claims, against American firms when their products have been counterfeited and the counterfeit products have failed to meet legal or warranty obligations.

U.S. Government Efforts

The most recent meeting of the JCCT secured China’s most specific promise to date on IPR protection for business software. The Chinese government pledged that future regulations would require computer manufacturers to pre-load computers with authentic operating system software. Government ministries would be required to purchase only computers that were pre-loaded with legal operating systems. Until now, most Chinese computers sold domestically had not been preloaded with software operating systems. This encouraged consumers to shop for the lowest-cost operating systems, which invariably are pirated.

USTR, recognizing that much of China’s IP problem is concentrated in specific areas and that enforcement primarily occurs at the local level, is promising a review of Chinese IPR protection efforts at the provincial level this year. In addition, it is gearing up to bring an IPR infringement case against China through the WTO.

The USTR also is expanding the staff dealing with IPR issues at the U.S. Embassy in Beijing. At its Washington headquarters, the USTR is creating a China Enforcement

Task Force. The USPTO stationed an IP attaché in Embassy Beijing and is due to add two additional IP attorneys this year.

The U.S. Government is expanding the tools it offers industry to protect its IP. It permits businesses to record trademarks directly with Customs and Border Protection agents. It is educating SMEs on how to protect their intellectual property. In 2004, the USTR and the Departments of Commerce, Justice, State, and Homeland Security established the Strategy Targeting Organized Piracy (STOP) Initiative. STOP provides a visible, accessible point in the federal government where businesses can report cases of IP infringement. But more needs to be done. For example, there is only one full-time senior State Department investigator on Intellectual Property issues at the U.S. Embassy in Beijing. This office should be expanded given the fact that China is the world's largest IPR violator.

WTO Dispute Mechanism and Other International Trade Remedies

The WTO dispute settlement mechanism should be a key tool to protect the IPR of U.S. businesses in an era of globalization. But the United States has seldom used this tool against China even though, in two of the three cases where it was employed, the process led to a satisfactory conclusion: negotiations to end discriminatory practices by China.

The reluctance of the USTR to use the WTO process to adjudicate trade disputes is partially attributable to weaknesses in the quasi-judicial WTO dispute settlement system itself. But there are other reasons. Some delay has been due to the USTR's preference for entering into negotiations with the governments of offending nations even before filing a WTO case. Even more important is the USTR's emphasis on building the strongest possible case and enlisting other countries as plaintiffs. And, to be fair, apparent foot-dragging by the government has sometimes been due to the reluctance of U.S.-based businesses to confront China because of fears that Beijing will withdraw favors and investment incentives from any company bold enough to speak out.

Given the complexity of such cases, USTR may need additional personnel or funds to hire outside investigators or counsel. Other agencies of government, such as the Department of Commerce, could also be enlisted to help bring such cases, particularly when U.S. businesses favor action but fear retaliation for their involvement.

The USTR currently is developing a WTO complaint based on China's failure to enforce international rules against piracy of motion pictures. In order to minimize the risk of retaliation against individual companies by Chinese authorities, the USTR is working through several industry associations and hopes to collaborate on that case with counterparts from the EU, Japan, and other trading partners.

While IPR enforcement may be primarily the province of local or regional officials in China, under WTO rules the central government bears ultimate responsibility for all trade-related matters and, in particular, for the actions (or inactions) of any level of government. The most likely successful WTO case for the U.S. would be based on TRIPS Articles 41 and 61, which provide that TRIPS members shall ensure they have effective enforcement procedures against IP infringement.

In addition to the WTO dispute settlement mechanism, the United States has used other WTO tools to place multilateral pressure on China. Last year, the United States, Japan, and Switzerland made simultaneous requests to China under the TRIPS Agreement to provide information on judicial decisions and administrative rulings related to IP theft.

Recommendations

- The Commission believes the WTO dispute settlement mechanism should be used more aggressively to enforce U.S. IPR in China, and recommends that Congress direct the Administration to pursue the WTO dispute settlement option on cases related to IP infringement and the lack of enforcement of IPR by China. If the USTR needs additional resources to investigate and prosecute such cases, the Commission recommends that Congress provide them.
- In order to facilitate a more aggressive approach toward defending pirated U.S. IP and pursuing other trade infractions, the Commission recommends that Congress strengthen and enlarge the international trade law enforcement prosecutor's office within the Office of the USTR.
- The Commission recommends that Congress direct the Administration to increase the number of IP attachés in China from the USTR, the USPTO, and the Departments of State, Commerce, Justice, and Homeland Security, and provide sufficient funding to the parent agencies to support these additional attachés.

The transcript, witness statements, and supporting documents for this hearing can be found on the Commission's website at www.uscc.gov. We hope these will be helpful as the Congress continues its assessment of China's intellectual property rights compliance.

Sincerely,



Larry M. Wortzel
Chairman



Carolyn Bartholomew
Vice Chairman

Cc:
Congressional members and staff